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Home Foreclosures: Will Voluntary Mortgage Modification Help Families Save Their Homes? Part II? : Hearing Before the H. Comm. on the Judiciary Subcomm. on Commercial and Administrative Law, 111th Cong., Dec. 11, 2009 (Statement of Associate Professor Adam J. Levitin, Geo. U. L. Center)

Adam J. Levitin
Georgetown University Law Center, ajl53@law.georgetown.edu

Georgetown University Law Center

Adam J. Levitin
Associate Professor of Law

Written Testimony of

Adam J. Levitin
Associate Professor of Law
Georgetown University Law Center

Before the
House of Representatives
Committee on the Judiciary
Subcommittee on Commercial and Administrative Law

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Witness Background Statement

Adam J. Levitin in an Associate Professor of Law at the Georgetown University Law Center, in Washington, D.C., and Robert Zinman Scholar in Residence at the American Bankruptcy Institute. He also serves as Special Counsel to the Congressional Oversight Panel.

Before joining the Georgetown faculty, Professor Levitin practiced in the Business Finance & Restructuring Department of Weil, Gotshal & Manges, LLP in New York, and served as law clerk to the Honorable Jane R. Roth on the United States Court of Appeals for the Third Circuit.

Professor Levitin holds a J.D. from Harvard Law School, an M.Phil and an A.M. from Columbia University, and an A.B. from Harvard College, all with honors.

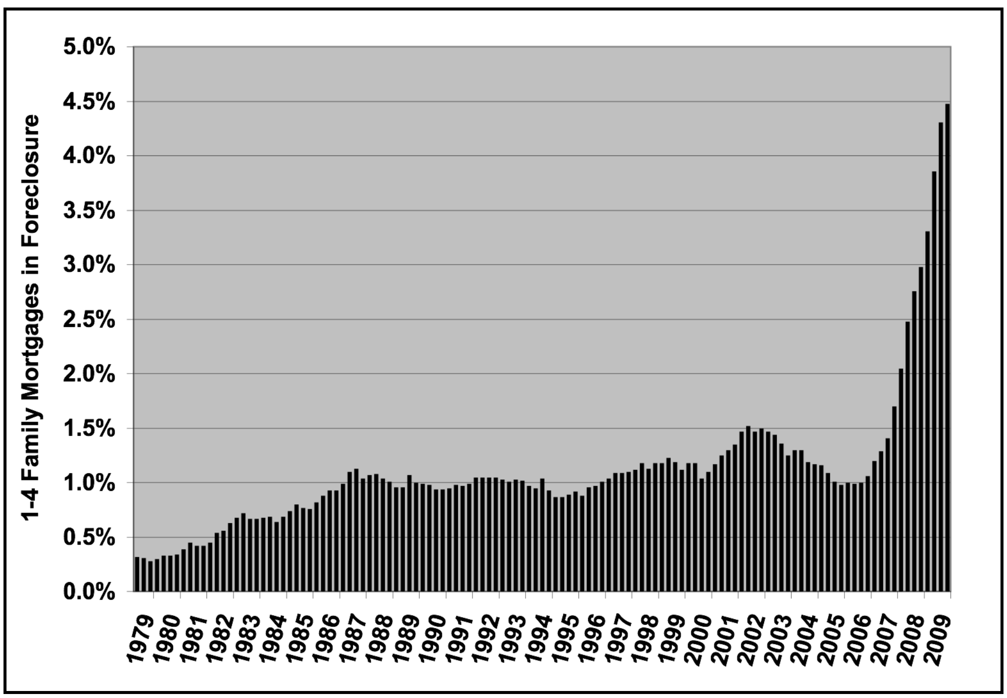
Professor Levitin has not received any Federal grants nor has he received any compensation in connection with his testimony. The views expressed in Professor Levitin's testimony are his own and do not represent the positions of the American Bankruptcy Institute or the Congressional Oversight Panel.

Mr. Chairman, Members of the Committee:

Good morning. My name is Adam Levitin. I am an Associate Professor of Law at the Georgetown University Law Center in Washington, D.C., where I teach courses in bankruptcy, commercial law, contracts, and structured finance. My research and writing focus on consumer finance and corporate bankruptcies. In particular, I have written about the obstacles to mortgage modification in the current crisis. I also serve as Special Counsel to the Congressional Oversight Panel for the Troubled Asset Relief Program, and am the Robert Zinman Resident Scholar at the American Bankruptcy Institute. The views I express today are my own.

We are now well into the third year of the foreclosure crisis, and there is no end in sight. Since mid-2007 nearly six million homes entered foreclosure,[1] and over two million borrowers lost their homes in foreclosure.[2] As of September 31, 2009, the Mortgage Bankers Association reported that 4.47% of 1-4 family residential mortgage loans were currently in the foreclosure, process a rate more than quadruple historical averages. (See Figure 1.) Additionally, 9.64% of mortgages were at least a month delinquent.[3]

Chart 1: Percentage of 1-4 Family Residential Mortgages in Foreclosure[4]



Unfortunately, no end is in sight. By the end of 2010, another 7 million homes are expected to enter foreclosure.[5] *Unless the crisis is abated, by the time it runs its course, as many as one in five residential borrowers will have gone into foreclosure.*

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[1] HOPE Now, Press Release, Dec. 2, 2009, *at* https://www.hopenow.com/press_release/files/October%202009%20Data%20Release.pdf (listing 5,710,039 foreclosure starts between July 2007 and September 2009).

[2] *Id.* (listing 2,018,873 completed foreclosure sales between July 2007 and September 2009).

[3] Mortgage Bankers Association, National Delinquency Survey.

[4] Mortgage Bankers Association, National Delinquency Surveys.

[5] *Not Much Relief*, NEW YORK TIMES, July 5, 2009, at WK7.

Private lenders, industry associations, and two successive administrations have made a variety of efforts to mitigate the crisis and encourage loan modifications and refinancings. A series of much hyped initiatives, such as the FHASecure refinancing program and the Hope4Homeowners have all met what can charitably be described as limited success. FHASecure, predicted to help 240,000 homeowners,[6] assisted only a few thousand borrowers before it wound down,[7] while Hope4 Homeowners, originally predicted to help 400,000 homeowners,[8] had closed only 94 refinancings as of September 23, 2009.[9]

The latest government attempt to address the foreclosure crisis is the Making Home Affordable Program (MHAP), and its two components, the Home Affordable Refinance Program (HARP) and the Home Affordable Modification (HAMP). Sadly, MHAP is also a failure, and Treasury's attempts to remedy the defects in the program are unlikely to fundamentally change its performance; there is no indication that MHAP will have a meaningful impact on the foreclosure crisis.

The following testimony provides a brief overview of MHAP, shows how MHAP is a failure by any metric, explains why Treasury's attempts to remedy the program are unlikely to have much impact, addresses potential causes of MHAP's failure, and considers potential alternative approaches.

I. Overview of HARP and HAMP

MHAP attempts to deal with the foreclosure crisis by encouraging the preemptive refinancing of at-risk mortgages through HARP and by modifying defaulted mortgages through HAMP. HARP permits current, owner-occupied, government sponsored enterprise (GSE)-guaranteed mortgages to refinance into a more sustainable GSE-eligible mortgage. Critically, HARP permits refinancings for homeowners with up to 125% LTV without requiring additional private mortgage insurance. Treasury estimates that HARP could assist between four to five million homeowners refinance.[10]

HAMP is a mortgage modification program that uses TARP funds to facilitate the modification of qualified mortgages through incentive payments to mortgage servicers, homeowners, and lenders. HAMP modifications are on a standard template that aims to reduce the monthly mortgage payment to 31 percent of the borrower's monthly income after all arrearages have been capitalized. This is done by first reducing interest rates incrementally to as low as 2 percent, then stretching out the loan's term if possible, and then stretching out the loan's

[6] *See, e.g.*, Press Release, US Dep't of Housing and Urban Development, Bush Administration to Help Nearly One-Quarter of a Million Homeowners Refinance, Keep Their Homes; FHA to implement new "FHASecure" refinancing product (Aug. 31, 2007), *available at* http://www.hud.gov/news/release.cfm?content=pr07-123.cfm; Press Release, US Dep't of Housing and Urban Development, FHA Helps 400,000 Families Find Mortgage Relief; Refinancing on pace to help half-million homeowners by year's end (Oct. 24, 2008), *available at* http://www.hud.gov/news/release.cfm?content=pr08- 167.cfm.

[7] Michael Corkery, *Mortgage 'Cram-Downs' Loom as Foreclosures Mount*, WALL ST. J.,, Dec. 31, 2008.

[8] Dina ElBoghdady, *HUD Chief Calls Aid on Mortgages a Failure*, WASH. POST. Dec. 17, 2008, at A1.

[9] Congressional Oversight Panel, *October Oversight Report: An Assessment of Foreclosure Mitigation Efforts After Six Months*, Oct. 9, 2009, at 83.

[10] U.S. Department of the Treasury, Making Home Affordable Summary of Guidelines (Mar. 4, 2009) (online at www.treas.gov/press/releases/reports/guidelines_summary.pdf).

amortization period (forbearing on principal).[11] To qualify for HAMP, a loan must be delinquent, for no more than conforming loan limit, and secured by an owner-occupied primary residence, and the homeowner must be employed. If the homeowner qualifies for HAMP, then the servicer is required to run a comparison of the net present value (NPV) of the value of the unmodified loan and the value of the loan if it were modified per HAMP guidelines. If the loan's NPV would be greater under a modification that without, the servicer is required to offer the borrower a modification, if a modification is permitted under the servicer's contractual restraints. If the modified NPV would be lower, the servicer is still permitted to offer a modification. A large number of GSE HAMP modifications have been NPV negative.[12]

HAMP modifications begin with a three-month trial modification.[13] If the borrower is current on payments at the end of the three-month trial period and has provided full supporting documentation, such as proof of income, then the modification becomes "permanent,"[14] and incentive payments commence.[15] "Permanent" modifications, however, have fixed monthly payments for only five years. After five years, interest rates on the modified loans increase up to a cap.[16] In addition, Treasury contributes cash toward interest-rate reductions, and it also provides a variety of incentive payments to the defaulted homeowner, servicer, and lender. Treasury does not make any incentive payments unless a modification becomes permanent.

Treasury hopes to modify up to three million to four million mortgages under the HAMP program,[17] and has stated that around 375,000 trial modifications are scheduled to become permanent before the end of the year.[18]

As of October 31, 2009, 136,271 loans have been refinanced under HARP. Only a small fraction of these refinancings—17,091 or 12.5 percent—were of mortgages with negative equity, and only a handful of refinancings—272 or .2 percent—involved mortgages with loan-to-value (LTV) ratios of over 105 percent.[19] A substantial number of HARP refinancings involved mortgages with LTV ratios in the range of 80-90 percent; these refinancings might well have been feasible even without HARP. Thus, the true impact of HARP is likely significantly lower than even the 136,271 refinancings to its credit.

For HAMP, as of October 31, 2009, Treasury has catalogued 919,965 offers of trial modifications,[20] 595,536 trial modifications on unique borrowers,[21] but only 10,187 permanent

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[11] U.S. Department of the Treasury, *Home Affordable Modification Program Guidelines* at 6-7 (March 4, 2009) (online at www.treas.gov/press/releases/reports/modification_program_guidelines.pdf).

[12] *See* Congressional Oversight Panel, *supra* note 9.

[13] Treasury has extended the trial period to five months for HAMP modifications commenced before September 1, 2009, and is likely to extend the trial period for all modifications.

[14] U.S. Department of the Treasury, *Making Home Affordable Summary of Guidelines* (Mar. 4, 2009) (online at www.treas.gov/press/releases/reports/guidelines_summary.pdf); Congressional Oversight Panel, *October Oversight Report: An Assessment of Foreclosure Mitigation Efforts After Six Months* (Oct. 9, 2009) (online at cop.senate.gov/documents/cop-100909-report.pdf).

[15] U.S. Department of the Treasury, *Home Affordable Modification Program Guidelines* at 11 (Mar. 4, 2009) (online at www.treas.gov/press/releases/reports/modification_program_guidelines.pdf).

[16] *See* Congressional Oversight Panel, *supra* note 9, at 4, 27, 47-48.

[17] U.S. Department of the Treasury, *Making Home Affordable: Updated Detailed Program Description* (March 4, 2009) (online at www.treas.gov/press/releases/reports/housing_fact_sheet.pdf).

[18] http://www.financialstability.gov/latest/tg_11302009b.html

[19] Congressional Oversight Panel, *December Oversight Report: Taking Stock: What Has the Troubled Asset Relief Program Achieved*? Dec. 9, 2009, at 63-64.

[20] U.S. Department of the Treasury, *Making Home Affordable Program: Servicer Performance Report Through October 2009,* at 3 (online at www.makinghomeaffordable.gov/docs/MHA%20Public%20111009%20FINAL.PDF).

modifications.[22] Only 4.69% of trial modifications have become permanent within three months.[23]

II. HAMP IS A FAILURE

HAMP is a failure. The ultimate success or failure of MHAP in general, and HAMP in particular, depends on the scale of relief that it can provide. It is patent that neither HARP nor HAMP will achieve anything near the scope of assistance that the administration projected or that will have a noticeable impact on the foreclosure crisis. The HOPE Now servicer alliance estimates that there are 3.47 million homeowners who are 60+ days delinquent on their mortgages as of the end of October 2009.[24] Yet, over its first eight months, MHAP has assisted less than 150,000 homeowners, and only around 10,000 who were delinquent. While improvements can be made to MHAP, there is no realistic possibility that HARP or HAMP will assist even a sizeable fraction of those who need help and qualify.

A. HAMP Has Produced Few Permanent Modifications

The performance of HAMP, in particular, is concerning, as HAMP is the component of MHAP designed to assist homeowners in the most dire situations. Treasury has continues to use trial modifications as its public yardstick for the success of HAMP. This metric is largely meaningless. Trumpeting the achievement of 500,000 trial modifications[25] has eerie tones of the "Mission Accomplished" triumph for the hardly resolved Iraq War.

The only meaningful measure of HAMP's success or failure is the number of foreclosures avoided solely because of the program. There is not a clear numerical benchmark for such success; we cannot expect HAMP or any other program to prevent all foreclosures. A reasonable benchmark, however, might be historic foreclosure rates, which have been about 1% of mortgages entering foreclosure in any given year. This would entail approximately a 75% reduction in a current foreclosure rate.

There are three obstacles that must be cleared for a HAMP modification to have avoided a foreclosure. First, a trial modification must commence. Second, the trial modification must convert to a permanent modification. And third, the permanent modification must not result in a redefault. Success on the first or second stage is futile unless the modified mortgage is stable and continues to perform.

Treasury has met with some success on the first stage; a large number of homeowners have signed up for HAMP trial modifications. As of October 31, 2009, there were 595,536 unique borrowers who had received HAMP trial modification since March 1.[26]

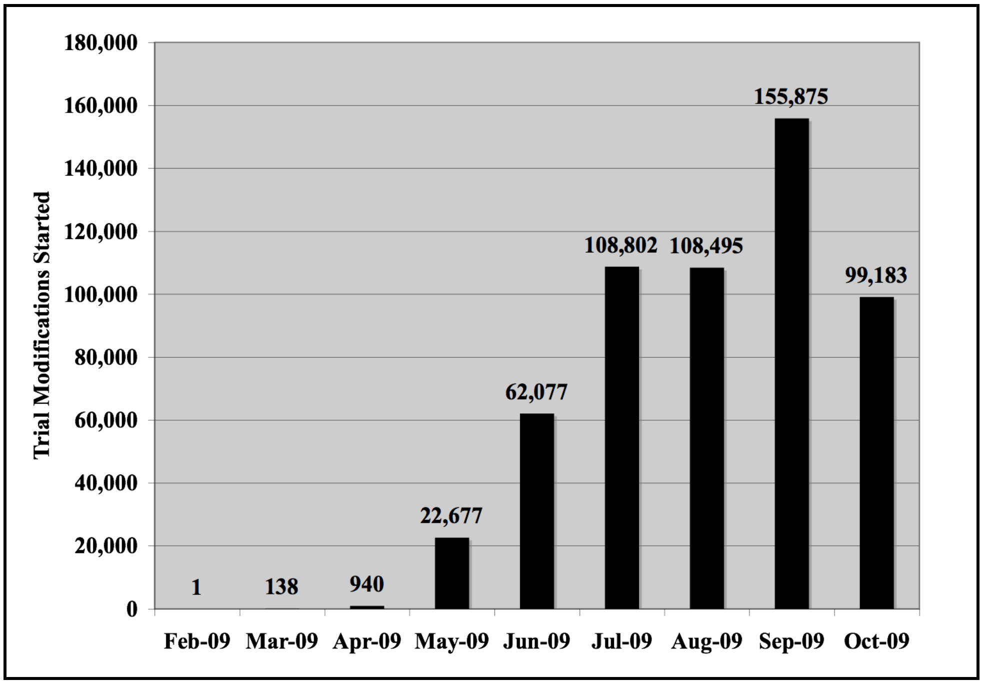
The significance of this step should not be overstated, however. First, we do not know the reason that many of the homeowners who were offered trial modifications did not receive them. Second, very little is necessary to commence a trial modification; it can be done on an entirely verbal basis. While the number of trials commenced is substantial, it is far less than the 3,470,000 homeowners who are 60+ days delinquent as of the end of October 2009, and less than

[21] Congressional Oversight Panel, *supra* note 19, at 64.
[22] *Id.*
[23] *Id.*
[24] HOPE Now, *supra* note 1.
[25] Peter S. Goodman, *Treasury Hails Milestone in Home Loan Modifications*, NY TIMES, Oct. 8, 2009, at B1.
[26] Congressional Oversight Panel, *supra* note 19, at 64.

the approximately 581,314 homeowners who have lost their homes in foreclosure between April 1 and October 31, 2009.[27]

A trial modification does temporarily lower a borrower's payments and stop foreclosure. Thus it provides borrowers with temporary relief. But unless the modification sticks, all a trial modification does is delay the foreclosure process by a few months. Moreover, there was a marked decline in the number of HAMP trial modifications commenced in October 2009, suggesting that the monthly trial enrollment in the program might have already peaked. (See Figure 2.)

Figure 2. Trial HAMP Modifications by Month



Treasury has had almost no success whatsoever at the second stage, converting trial modifications to permanent status. Treasury originally assumed that 50-75 percent of the trial modifications would convert into longer-term modifications.[28] Even now, Treasury notes that "Roughly 375,000 of the borrowers who have begun trial modifications since the start of the program are scheduled to convert to permanent modifications by the end of the year."[29] Scheduled is quite different from likely. It would be a remarkable accomplishment if even ten percent or 37,500 of those borrowers achieve permanent modifications by year's end. As of October 31, there were but 10,187 permanent modifications, meaning that only 4.69% of HAMP trial modifications converted to permanent after the originally allotted three-month trial period.[30]

[27] HOPE Now, *supra* note 1.

[28] *See* Congressional Oversight Panel, Transcript Testimony of Treasury Assistant Secretary for Financial Stability Herbert M. Allison, Jr., *Congressional Oversight Panel Hearing with Assistant Treasury Secretary Herbert M. Allison, Jr.*, at 22-23 (Oct. 22, 2009) (forthcoming cop.senate.gov/hearings/library/hearing-102209-allison.cfm).

[29] http://www.financialstability.gov/latest/tg_11302009b.html

The net result of the modifications was that median (mean) monthly principal and interest payments dropped $500.25 ($598.49), from $1,419.43 ($1,554.14) to $849.31 ($955.65), a 35 (39) percent decline. [30] Congressional Oversight Panel, *supra* note 19, at 64

B. Most HAMP Modifications Will Redefault Within Five Years

The extremely low number of permanent HAMP modification is itself discouraging, but even more discouraging are the predicted redefaults. Even thought HAMP modifications drastically lower borrower's monthly payments (the median monthly principal and interest amount declined 35% from $1,419.43 to $849.31),[31] redefaults are still likely to be high. Treasury's baseline prediction for redefaults is 40%.[32] Given the actual characteristics of HAMP modifications, however, significantly higher redefault rates are expected. In other words, HAMP is producing very few permanent modifications, and around half of them, if not more, will likely redefault within 5 years. Over the life of the loan, the redefault rate will be even higher. Assuming a (charitable) 50% redefault rate, HAMP has permanently avoided only around 5,000 foreclosures in 8 months, and some of which might have been avoided without taxpayer-funded incentive payments to servicers.[33]

High redefault rates should not be surprising for HAMP. Even though HAMP makes payments on modified loans initially affordable, HAMP modifications frequently result in loans that share many of the characteristics of the exotic, subprime mortgages that kindled the financial crisis: low, below-market introductory rates that step up over time, extremely high loan to value ratios, and balloon payments, either because of amortization periods that are longer than the loans' terms or forborne principal. Indeed, because of the deep level of negative equity, HAMP modified-loans actually look worse than some of the subprime loans made during the housing bubble. These loans were eminently affordable when at their teaser rates, but their sustainability was always suspect. So too are HAMP modifications. HAMP modifications are five-year modifications, no more.

C. Treasury's New Conversion Drive Is Unlikely to Have a Noticeable Impact

Because of the poor conversion rate from trial to permanent, Treasury has recently announced that it will engage in an aggressive campaign of moral suasion to encourage servicers to convert more modifications to permanent status. As part of this campaign, Treasury states that it will require servicers to submit action plans, engage in greater monitoring of servicer's conversion rates, release data on individual servicer's progress in converting trial modifications to permanent, and even possibly withhold payments from servicers and impose monetary penalties and sanctions.[34]

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[31] Congressional Oversight Panel, *supra 9*, at 54.

[32] *See* Congressional Oversight Panel, Transcript Testimony of Treasury Assistant Secretary for Financial Stability Herbert M. Allison, Jr., *Congressional Oversight Panel Hearing with Assistant Treasury Secretary Herbert M. Allison, Jr.*, (Oct. 22, 2009) (Response to Questions for the Record).

[33] There are still a significant number of non-HAMP modifications occurring, although the number has declined substantially since the creation of HAMP. Thus in the first quarter of 2009, HOPE Now reported 370,436 private modifications, while only 236,734 in the third quarter of 2009. Whether these modifications are comparable with HAMP modifications in terms of affordability and sustainability is unclear.

To be sure, even if a HAMP modified loan redefaults, foreclosure is not the inevitable outcome; the servicer is free to attempt another modification (albeit without a federal incentive payment). Indeed, it is important to underscore that many mortgages have already been modified multiple times. Therefore, mortgage modification statistics that report the number of modifications or repayment plans enacted need to be discounted to reflect the number of unique borrowers helped.

[34] http://www.financialstability.gov/latest/tg_11302009b.html.

There are two problems with this approach. First, it is not apparent that Treasury itself understands why there are so few modifications converting from trial to permanent. Until and unless this is determined, attempts to rectify the situation will have haphazard results.

Second, Treasury has limited ability to pressure servicers, and, to date, it has shown little appetite to apply serious pressure. Treasury has known about low conversion rates for months, yet still appears reluctant to attempt to shame servicers into action. Treasury has indicated that it will release data on individual servicers' conversion rates, but not until January 2010.[35] Likewise, news reports indicate that Treasury will begin to pay servicers only upon modifications becoming permanent.[36] This is not a change to HAMP; Treasury has never made any payments under HAMP, except when modifications become permanent.

Similarly, as part of its "Conversion Drive," Treasury has stated, "[s]ervicers failing to meet performance obligations under the Servicer Participation Agreement will be subject to consequences which could include monetary penalties and sanctions." Treasury, however, has no authority to impose monetary penalties and sanctions. There is no such authority in law or under Servicer Participation Agreements.[37] The Servicer Participation Agreements allow Treasury to recoup funds paid for nonconforming modifications, but do not provide Treasury with any tools to penalize servicers for insufficient numbers of modifications. Treasury could withhold payments it is contractually obligated to make, but doing so risks servicers stopping all modification efforts. Similarly, public shaming measures bear the risk of backlash or even litigation. If Treasury is dissatisfied with servicer performance, its only real remedy is to bring suit for breach of contract, an exceedingly unlikely scenario. Treasury has the ability to bark, but not bite, and servicers know it, which makes moral suasion unlikely to affect change.

Even if Treasury is able to substantial increase conversion rates, they will never approach 100%, and many permanent modifications will still redefault. (See Figure 3.) In October 2009, there were 222,107 foreclosure starts,[38] significantly more than the 99,183 HAMP trial modifications initiated in the same month.[39] In October there were also 94,450 completed foreclosure sales.[40] To keep pace with completed foreclosure sales, 95 percent of trial modifications in October would have to convert to permanent modifications *with no redefaults on the modifications*.

Treasury's own initial assumptions of a 50-75% conversion rate and a 40% redefault rate indicate a predicted "success rate" of prevented foreclosures as a percentage of trial modifications between 20% and 30%. Thus, at best we can hope for HAMP to reduce foreclosure rates from four and a half times their historic levels to three times historic levels. This would be an improvement, no doubt, but a hardly a resolution of the foreclosure crisis, and more realistic assumptions produce substantially lower "success rates." To use a different conversion analogy, a two-point conversion is meaningless when a team is down by four touchdowns in the forth quarter.

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[35] http://www.financialstability.gov/latest/tg_11302009b.html (the December 2009 MHA Report comes out in January 2010).

[36] Peter Goodman, *U.S. Will Push Mortgage Firms to Reduce More Loan Payments*, N.Y. TIMES, Nov. 28, 2009, at A1.

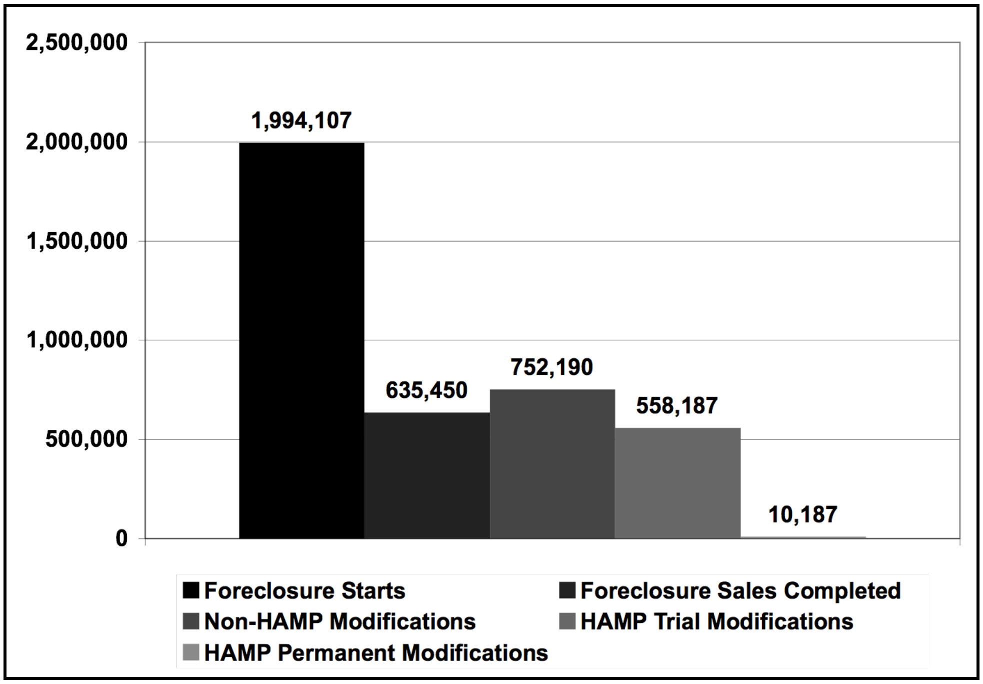
[37] Servicer Participation Agreement, *at* https://www.hmpadmin.com/portal/docs/hamp_servicer/servicerparticipationagreement.pdf.

[38] HOPE Now, *supra* note 1.

[39] Congressional Oversight Panel, *supra* note 19, at 63-64.

[40] HOPE Now, *supra* note 1.

Figure 3. Foreclosures vs. Modifications (Cumulative March-October 2009)[41]



III. WHY HAS HAMP FAILED?

The reasons for HAMP's failure are not yet clear. There are several possibilities.

A. Limited HAMP Eligibility

There are factors limiting the HAMP eligibility. HAMP may simply be too restrictive in a number of ways. HAMP requires borrower employment. HAMP was designed when unemployment was significantly lower than today. Unemployment has become a major cause of mortgage delinquency, yet for borrowers who are delinquent because of unemployment, HAMP offers no assistance.

HAMP's DTI requirements also limit eligibility. HAMP requires modified loans to be at 31% and loans with premodification DTI of less than 31% are not eligible. The postmodification 31% DTI requirement means that some borrowers will not be able to qualify because the NPV on their loan, if modified, would be less than in foreclosure. Some of these borrowers would qualify, however, at slightly higher DTI ratios.

Conversely, the requirement that loans have a premodification DTI over 31% may also be too restrictive. The premodification 31% DTI requirement looks only at DTI per loan. There are some borrowers with multiple loans, each of which is at less than 31% DTI. These borrowers are ineligible for HAMP, although their total mortgage debt burden is well above 31% DTI.

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[41] U.S. Department of the Treasury, *Making Home Affordable Program: Servicer Performance Report Through October 2009,* at 3 (online at www.makinghomeaffordable.gov/docs/MHA%20Public%20111009%20FINAL.PDF) (accessed Dec. 7, 2009); HOPE NOW, *Latest HOPE NOW Data Shows Workout Solutions Outpace Foreclosures More than 3 to 1* (Dec. 2, 2009) (online at www.hopenow.com/press_release/files/October%202009%20Data%20Release.pdf); *Workout Plans (Repayment Plans + Modifications) and Foreclosure Sales, July 2007- September 2009* (online at www.hopenow.com/industry-data/HOPE%20NOW%20National%20Data%20July07%20to%20Sep09%20v2.pdf) (accessed Dec. 7, 2009).

HAMP is also restricted to owner-occupied properties. The negative externalities from a foreclosure do not depend on whether a property is owner-occupied or not, and renters also suffer in foreclosures. While the desire to avoid bailing out investors in understandable, investors in bank securities, GSE securities, private-label mortgage backed securities, and various asset-backed securities have all been bailed out directly or indirectly, so it is hard to make a case for treating owners of investment properties differently.

B. Borrower-Side Problems

The low conversion rates for HAMP modifications relate in part to borrower-side problems. HAMP trial modifications may be done on a verbal basis, but a permanent modification requires full documentation. Obtaining full documentation from borrowers is frequently difficult and delays conversion to permanent status. Borrowers are not good at managing paperwork, and some of HAMP's documentation requirements, such as requiring both tax returns and current pay stubs are redundant (tax returns speak to past income, which is of little relevance). Centralization of paperwork collection through a web-based portal would reduce paperwork problems; it would also help eliminate the frequently reported problem of servicers losing or claiming never to have received paperwork, as the paperwork could be easily be verified and retrieved from the web portal.

Another borrower-side problem is inability to make the trial modification payments. It is unknown how many borrowers have had payment defaults on trial modifications; a borrower can run 60 days delinquent and still qualify for a permanent modification, so long as all payments are made within the close of the trial period.

Longer-term, HAMP's inability to deal with unemployment and negative equity will contribute significantly to redefaults. HAMP has no solution for borrowers who receive permanent modifications and subsequently lose their jobs. Likewise, HAMP has no solution for negative equity. HAMP permits servicers to forgive principal, but there have been only a handful of permanent modifications involving principal forgiveness. Instead, servicers are forbearing on principal, meaning that it will have to eventually be repaid when the loan is paid off (including via a refinancing). The result is that HAMP modifications leave borrowers mired in deep negative equity; the median post-modification LTV is around 124%.[42]

Homeowners with negative equity have diminished incentives to care for their properties and might rationally abandon the property, if the loan is non-recourse or functionally non-recourse, and take up in cheaper rental property.

Homeowners with negative equity are also constrained in their ability to move, absent abandoning the house to foreclosure. There is a wide range of inevitable life events that necessitate moves: the birth of children, illness, death, divorce, retirement, job loss, and new jobs. Indeed, these are the primary reasons why homeowners move in the first place. When one of these life events occurs, if a homeowner has negative equity, the primary choices are between forgoing the move, finding the cash to make up the negative equity, or losing the house in foreclosure. Many will choose the foreclosure route.

One potential solution to the negative equity problem within the HAMP framework is to revise the HAMP NPV calculation to strongly differentiate redefault rates based on LTV in order to encourage principal forgiveness. Such a solution would only work, however, if NPV's of

[42] Congressional Oversight Panel, *supra* note 9, at 54.

lower LTV loans were increased, rather than the NPV's of high LTV loans decreasing, as the later would disqualify more loans mandatory modifications.

C. Servicer-Side Problems

A variety of servicer-side problems may also be contributing to HAMP's failure. First, HAMP modifications are subject to any contractual restraints servicers have with investors. These restraints vary and rarely prohibit modifications, but the do often restrict term extensions and principal reductions.[43] Second liens also present servicers with an obstacle; first lien holders are reluctant to undertake modifications unless the second lienholder takes the first loss, and from the borrower's perspective, it is the total mortgage burden, not simply the payments to the first lienholder that matter. Therefore, unless modifications reduce payments to second lienholders, they are of limited benefit. HAMP has a new second-lien program, but to date it has not had any impact on the second lien problem.

Third, servicers may simply lack the capacity to handle the volume of modifications in a timely fashion. Servicers are not in the business of loan modification; the servicing business is primarily one of transaction processing, and it relies on automation and economies of scale. Loan modification is a manpower- and discretion-intensive undertaking involving underwriting, rather than transaction processing, and it is unreasonable to expect servicers to execute a quick or easy transition to this new line of business.

Fourth, HAMP may not have properly calibrated incentive payments to encourage servicers to perform permanent modifications. HAMP may be a money loser for servicers. Trial modifications are fairly cheap for servicers; there are significant additional expenses to covert a modification to permanent. HAMP incentive payments are made only for permanent modifications. Therefore, if a servicer anticipates one successful permanent modification for every ten trials, then the servicer will divide the incentive payment by ten. Unless that tenth of an incentive payment covers the marginal cost of attempting a permanent modification, servicers will be reluctant to expend additional effort attempting to convert trial modifications to permanent if they do not believe they will be successful.

IV. POTENTIAL STEPS FORWARD

There are improvements that could be made to HAMP, but none will fundamentally transform it. In order for a program to be successful it must address (1) problems with servicers' contractual restrictions, capacity and incentives, (2) negative equity, and (3) unemployment. There are a number of ways to address servicer-side issues and negative equity; unemployment, however, presents a major challenge.

A. National Mediation Program

One possibility for foreclosure mitigation is to implement a national mediation program as a prerequisite to foreclosure. A mediation program could also be combined with a standing government offer to refinance via FHA at 97% LTV with 31% DTI payments. A mediation program in Philadelphia has had some success; elsewhere, however, the results have been mixed.

[43] *See, e.g.*, Anna Gelpern & Adam J. Levitin, *Rewriting Frankenstein Contracts: Workout Prohibitions in Residential Mortgage-Backed Securities*, 82 S. CAL. L. REV. (forthcoming 2009).

A recent study of a New York state mediation program found that in most cases the lender or servicer's representatives appeared without knowledge of the case or authority to settle.[44]

There are two things that can be accomplished by mediation. Mediation imposes delay, and delay is costly to lenders and servicers. The prospect of additional cost from delay might encourage more settlements. But it might also drag out the crisis. Delay via mediation does not sort between homeowners who can afford to pay a reasonably modified mortgage and those who have no ability to pay any reasonable modification.

B. Permit Mortgage Modification in Chapter 13 Bankruptcy

A second possibility to amend Chapter 13 of the Bankruptcy Code to permit modification of single-family principle residence mortgages and to allow greater flexibility in the modification of other mortgages.

Permitting the modification of single-family principle residence mortgages in bankruptcy would create a mechanism that would address the negative equity problem as well as the affordability problem, while denying relief to speculators who would abuse the system and to homeowners who cannot realistically afford even a modified mortgage.[45] Bankruptcy modification would bypass contractual, capacity, and incentive problems on the servicer side. It would also be immediately available and would have no additional cost to the taxpayers, and it would not result in higher mortgage costs or less mortgage credit availability as long as lenders' foreclosure losses remain greater than bankruptcy modification losses.

Bankruptcy modification would not yield a windfall to housing speculators or second home purchasers and would only help homeowners who could ultimately afford a reasonable mortgage. A mortgage loan modification in bankruptcy can occur only as part of a repayment plan. The automatic stay would likely be lifted on an investment property (or second home) before a plan could be confirmed. Accordingly, speculators and homeowners intent on keeping their second homes are unlikely to file for bankruptcy to seek mortgage modification in the first place.

To qualify for Chapter 13 bankruptcy, in which a loan can be modified, there must be at least one regular income in the homeowner's household,[46] and Chapter 13 plans must be feasible given the debtor's means.[47] This does not mean that any modification is permissible; federal common law of bankruptcy requires that modified loans reflect a reasonable risk premium for the debtor,[48] and the Bankruptcy Code requires that a mortgagee receive at least the present value of the property.[49] Only a debtor who can afford a loan modified within these limits will be able to

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[44] Center for New York City Neighborhoods, *Locked Out: Little Relief for NYC Homeowners in the Foreclosure Settlement Process,* 2009 Report.

[45] It is important to emphasize, however, that even with cramdown, Chapter 13 cannot help a homeowner, unless the homeowner has regular income. Regular income is a threshold eligibility requirement for Chapter 13. In a two-earner family, there need be only one regular income, but if a family's difficulty in paying its mortgage is caused by unemployment of the sole earner, Chapter 13 would not be an option. The reason I emphasize the importance of regular income for Chapter 13 eligibility is that unemployment will be a major factor in the coming wave of foreclosures.

[46] 11 U.S.C. § 109(e) (2005).

[47] 11 U.S.C. § 1325(a)(6) (2005).

[48] Till v. SCS Credit Corp., 541 U.S. 465 (2004).

[49] 11 U.S.C. § 1325(a)(5) (2005). *See* Stan Leibowtiz, *New Evidence on the Foreclosure Crisis*, WALL ST. J., July 3, 2009; Congressional Oversight Panel, *The Foreclosure Crisis: Working Toward a Solution*, *at* http://cop.senate.gov/reports/library/report-030609-cop.cfm.

keep her home. Permitting bankruptcy modification of primary home mortgages thus steers a true course between extending the right sort of relief and not extending it too broadly.

C. Create a Special, Streamlined Prepackaged Mortgage Bankruptcy Chapter (Chapter M)

A third possibility is not to utilize Chapter 13, but instead to create a special, streamlined prepackaged mortgage bankruptcy chapter ("Chapter M"). In a Chapter M, all foreclosure actions would be automatically removed from state court to federal bankruptcy court. If the lender prevailed in the foreclosure action, then the homeowner would be offered a standardized pre-packaged bankruptcy plan. The plan could be based on HAMP modification guidelines (interest rate reduction to achieve 31% DTI goal, but without federal funding) plus cramdown to address negative equity.

If the homeowner were willing and able to pay under the plan, the homeowner would keep the house. Otherwise, the foreclosure sale would be completed on an expedited, standardized basis (say 45 days to sale) through a bankruptcy trustee's sale, which gives good title to the purchaser. The homeowner's non-mortgage debts would "ride-thru" unaffected. If the homeowner redefaulted, the same expedited foreclosure process would apply.

A Chapter M process would address negative equity (including second liens), as well as affordability. It would also remove mortgage servicers from the modification process, thereby eliminating servicer capacity and incentive issues.

A Chapter M might be more attractive to mortgage lenders than traditional Chapter 13 cramdown option because it offers a fast-tracked, standardized foreclosure process, quick foreclosure upon redefault, court-ordered protection of property against homeowner destruction during foreclosure, and the ability to provide clean title.

Chapter M would have no affect on non-mortgage lenders. Like Chapter 13 modification, Chapter M would have no cost to the federal government and would be immediately available, using existing courts and Chapter 7 panel trustees for sales. Unlike Chapter 13, Chapter M would avoid the adverse selection problem, as all homeowners in foreclosure choose between paying per standardized terms or losing the house quickly.

Chapter M could provide for a quick reset for housing market. But it also poses the risk of releasing a glut of properties on the market. Because lenders would trigger the process via filing a foreclosure action, it is ultimately in their control. Perhaps most significantly, Chapter M would not address problems of unaffordability due to unemployment or total consumer debt burdens.

D. Encourage Forbearance to Deal with Unemployment

Unemployment presents the greatest single challenge to foreclosure mitigation, as without income (or significant savings), no modified mortgage payment will be feasible. The difficulty faced by a lender is that it does not know whether the borrower's unemployment will be short-term or long-term or whether income from new employment will be comparable to that from the prior employment. If the unemployment is short-term and the new employment provides comparable income to the borrower, then forbearance is often a sensible solution, particularly when the borrower has equity in the property or the market is appreciating. Unfortunately, there is not a good mechanism for sorting among unemployed homeowners to determine who is a good risk for forbearance and who is not.

To the extent that Congress wishes to encourage forbearance, it is possible to do indirectly by imposing procedural hurdles to foreclosure, such as mandatory mediation or through tax or Community Reinvestment Act credits or by adjusting regulatory capital requirements. Risk-based capital requirements have already been lowered to encourage HAMP modifications. Instead of the normal 100% risk-weighting assigned to restructured loans, HAMP modified loans receive 50% risk-weighting.[50]

All of these methods for encouraging forbearance have drawbacks. Imposing delay has the effect of prolonging instability in the housing sector and delaying foreclosures on properties where there is no economic modification possible. Adjustments to risk-based capital have no impact on securitized mortgages, and there are definite risks to such an approach; risk-based capital requirements are safety-and-soundness devices and adjusting them in pursuit of other policy goals can undermine safety-and-soundness regulation.[51]

V. Conclusion

The results to date from MHAP are deeply disappointing. Even the most optimistic view of HAMP and HARP's potential would now project the programs as having only a minor impact on the foreclosure crisis. Until and unless the problems of unemployment; negative equity, and servicer capacity, incentives, and contract restrictions are addressed, we are unlikely to see noticeably different results. These issues cannot be addressed within the current structure of HAMP.

Unfortunately, none of the solutions for foreclosures due to unemployment are particularly satisfying, and without addressing unemployment, foreclosures will remain at elevated levels. Bankruptcy presents possible solutions to negative equity as well as to servicer-side problems of capacity, incentives, and contractual restrictions, as it removes servicers from the modification business. A bankruptcy solution is not a silver bullet that will end the foreclosure crisis, but if negative equity and servicer-side problems can be successfully addressed, it will result in significant progress in foreclosure mitigation.

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[50] *See, e.g.*, 12 C.F.R. Part 3, Appendix A, § 3(a)(3)(ii) ("For the purposes of the risk-based capital guidelines, a loan modified solely pursuant to the U.S. Department of Treasury's Making Home Affordable Program will not be considered to have been restructured.").

[51] Indeed, this speaks to the need to separate safety-and-soundness regulation from regulation in pursuit of other policies.